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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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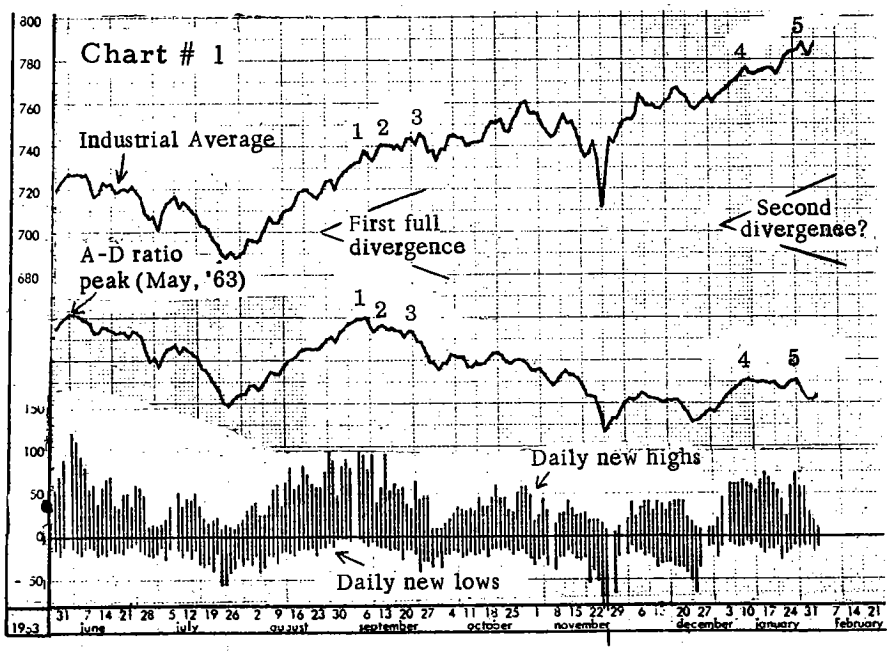
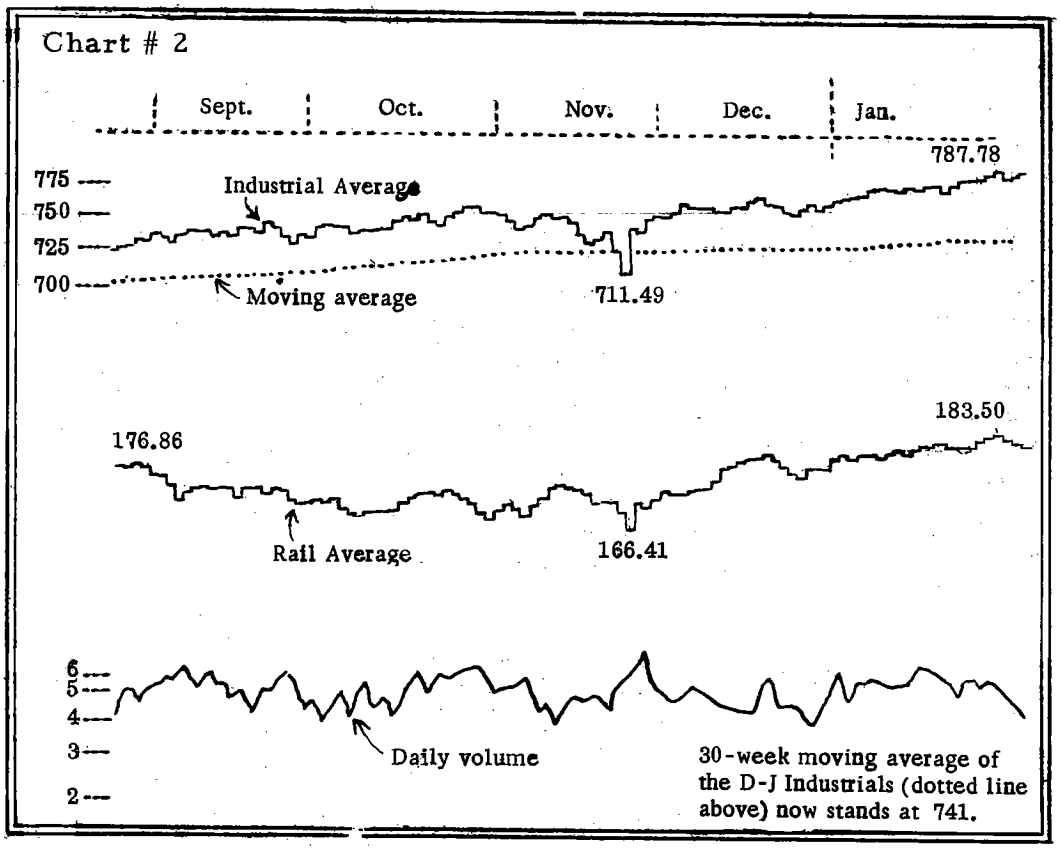
QUESTION: Why do you give so much attention to the advance-decline ratio these days, particularly in view of the rise in the two Averages to historic highs? In 1958 and '59 you wrote much less about breadth — what has changed?

ANSWER: Market analysis has been termed 10% science and 90% "art" or intuition. At a given period, one study seems to be telling us the story of what is occuring in the market; a few years later another study appears to be offering the truer picture. In my opinion, the most important market "story" at this time is the one provided by the Industrial Average - A-D ratio studies. For this reason, I have included a Special Study of the breadth-price relationship with this Letter. For not only is the current breadth-price action showing us that the short-term picture is one in which the majority of stocks are simply refusing to follow the Averages to higher ground, but the monthly breadth-price relationship (see Special Study) is showing us that this process has been going on for a number of years. In other words, the refusal of the majority of stocks on the N. Y. S. E. to push out with the "blue-chip" issues is one of the basic problems facing investors today.



I have ventured the prediction that 1964 is fated to be a year of high excitement on Wall Street. Events so far this year have only served to fortify that opinion, and last week's action was no exception. On January 27, the Industrial and Rail Averages rose to new highs — Industrials to an all-time high and Rails to their highest level since September, 1929. On January 28 the two Averages pushed to further new highs — Industrials closed at 787.78, Rails at 183.50. Volume, however, dipped noticeably on both days (see Chart 2).

But the incredible part of this two-day performance was that on January 27, 201 more issues declined than advanced (daily new highs amounted to 60), and on January 28, 181 more issues declined than advanced (new highs totaled 30). This incongruous technical display gave way to a



broad decline on January 29, a decline which saw Industrials drop 5.18 points, Rails drop 1.39 — while 412 more stocks declined than advanced.

It is probable that a remarkable technical sequence is now unfolding, and I urge subscribers to study the following discussion carefully. The "signal" which has prefaced the majority of important stock market declines since 1919 is the full breadth-price divergence. For the convenience of subscribers, I have reviewed this phenomenon on the small diagram on the second page of the green-tinted Special Study.

The classic divergence pattern of three peaks in the Industrial Average against three successive lows in the A-D ratio was last seen during the period of September 5 to 23, 1963. Following that show of major technical weakness, the market began a decline which ended (for the Averages) with panic selling at the "Kennedy assassination lows". That picture is illustrated on Chart # 1, and the three diverging peaks are number 1, 2 and 3.

Following the assassination lows, the Averages rose to new highs, and the A-D ratio staged a recovery (Chart 1) which lasted for thirty trading days — from November 22 to January 9, 1964. On January 9 (peak 4 on chart) the A-D ratio again turned down, this time declining to a low on January 21. A new rally carried Industrials to an all-time high on January 24 (peak 5 on chart). But last week's weakness served to reverse the recovery pattern of the A-D ratio, and on January 29 the ratio dropped to its lowest level since January 2. The renewed weakness shown by the A-D ratio is a clear sign that the majority of Big Board stocks are again unable to follow the Averages on the upside, and, in fact, most stocks are now only too willing to move sideways or down.

The total market picture is poor enough as it stands, but it is possible that another element of weakness is about to appear. If a new rally succeeds in taking the Industrial Average above its January 28 peak of 787.78 (peak 4), the stage will be set for a second full breadth-price divergence. Following a possible Industrial bettering of 787.78, a fresh decline taking the A-D ratio to a new low would complete a second major "sell" signal.

I hasten to explain, however, that a new breadth-price divergence would merely intensify the bearish picture which already exists at this time. As far as this writer is concerned, the market is (and has been for many months) weak enough to justify a "sideline position", and I have repeatedly warned subscribers of the difficulty of "fighting" the declining trend of the majority of stocks on the N. Y. S. E.

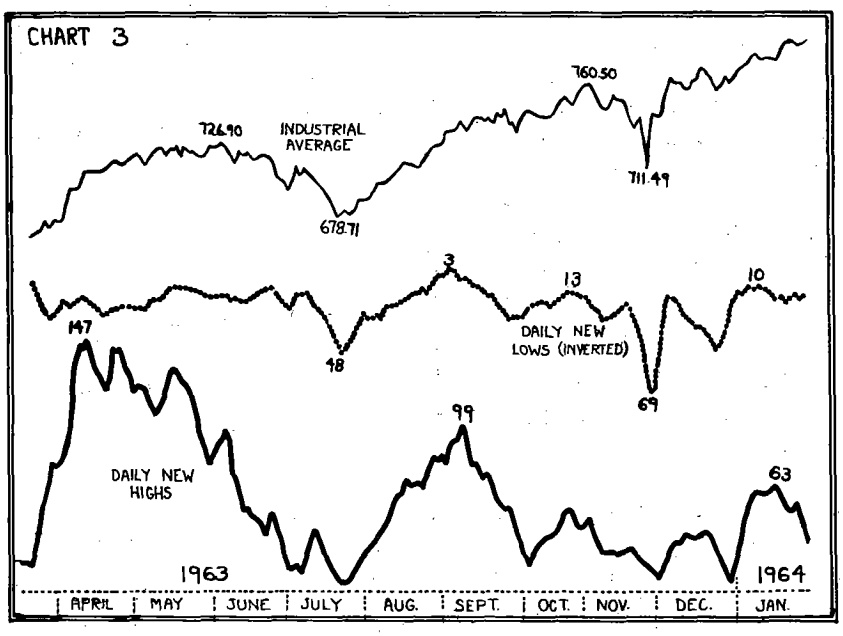
HIGHS AND LOWS: During a major bull movement, it is normal to see stock after stock push out of their established patterns and rise to new highs for the year. If the upward momentum continues, those stocks which recorded new highs will continue to rise, and they will be joined by fresh "breakouts" which will also augment the "new high parade".

But when a bull movement shows a steady decrease in the number of new highs, it is a sign that the original rallying strength is ebbing. Such a market, regardless of temporary rallies or confusing fluctuations, may be said to be "living on borrowed time". It is axiomatic that diminishing strength during a market advance will gradually turn into increasing weakness. By the same token, decreasing weakness during a market decline will materialize into growing strength.

In view of the above, it is well worth studying the twelve-month chart of daily new highs and daily new lows (Chart # 3). The new high and low lines are presented in the form of five-day moving averages so that erratic fluctuations can be "smoothed out" and the underlying trend more easily followed. The new low line has been inverted so that it will tend to move in the same direction (and thus confirm) the new high line.

Note that the peak of market strength, as measured by new highs, appeared in early April, 1963 (five-day average of new highs at the April peak — 147). During the July, 1963, decline, the new high index dropped drastically, while the new low index expanded to a five-day average of 48. The rally into September produced a reading of 99 on the new high index (well below the April total) — and this in the face of an historic high in the Industrial Average.

During the October-November weakness which terminated at the "assassination-panic lows", new lows expanded to 69 while new highs contracted sharply. The recovery from the panic lows carried into January, 1964, but note that in January the new high index climbed to an unimpressive peak of 63. Moreover, even while this was occurring the new low index was refusing to contract to lower than 10.



The cold statistics reflected in Chart # 3 need little in the way of explanation. They show a picture of steadily diminishing strength masquerading under the guise of new highs in the Averages. Chart # 3, in fact, merely confirms what we already know from our breadth studies. Parenthetically, it is interesting to note that the new high index gave one of the earliest warnings, and it "topped out" in April, almost two months before the final peak in the A-D ratio.

The new high index has had nine months in which to better its early 1963 peak of 147. Furthermore, those nine months saw a succession of historic highs in the Averages. The conclusion would appear to be inescapable — market strength has diminished to the point where it is turning into increasing and rather obvious weakness.

SUNDRY COMMENTS: From a privately-distributed letter written by a veteran West Coast broker (L. T., January 23, 1964): "Naturally, our memory of the doings in '28 and '29 is rather hazy. We rarely make extravagant statements here, but it seems that the market of the past week or so has some of the flavor of '28 and '29. In some people, age tends to make for a bit of caution. During yesterday's heavy buying in blue-chips, Polaroid was at one time up $6 — Litton down $3, Chrysler down $2, Sears up $4, Proctor and Gamble up $3. It's possible we're entering a phase which is no market for the novice, and maybe not for the veteran either."

The following is from a letter written by Charles Merrill (of Merrill, Lynch) in the year 1939: "... and the factor most frequently forgotton but obviously one of considerable importance is that if one is to buy securities when they are cheap, he must have the money available. Now the only way to have the money available is to earn it and set it aside for this specific purpose, or else to have the foresight to liquidate securities when they are high and let the money remain idle or invest it in good, short-term securities awaiting the time when securities are being thrown overboard regardless of their real value."

And finally, a quote from Robert Rhea's description of the 1929 market: "During the last three months of the excitement it was not unusual for a stock to advance more in one week than it could earn in five years. It was obvious that prices were quoted on hopes and expectations, rather than on any reasonable appraisal of present or future value. Bonds which were first mortgages on the earnings and physical assets of corporations were, in many cases, yielding more than the common stocks of those companies."

An up-dated comment: American Telephone common (figured on a price of 146) now provides a yield of 2.74% on its new dividend. American Telephone's bonds now offer a yield of about 4.37%.

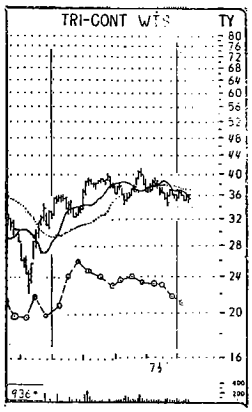
* * * *

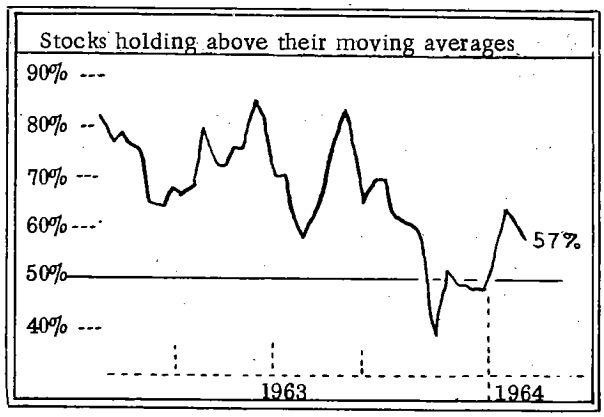
A subscriber writes to ask why I "cannot be more optimistic. If nothing else," he adds, "I am sure such an attitude would bring you more subscribers — and quickly." (R. S., Boston, Mass.) Without intending sarcasm, I believe I can present the case for increasing optimism as far as investors (in the true sense of the word) are concerned.

Sometime during the first four years of every decade in this century, the D-J Industrial Average has been priced to afford an average yield of 6% or more. These bountiful yielding years include 1903, 1913, 1920, 1931-32, 1940-42, 1950-52. If the Dow does not provide an average yield near 6% shortly, we will have broken a record that has endured throughout the twentieth century. For if, by definition, investors are people who know "values" (and common stocks are not values at these levels), then it follows that most true investors are now in a largely cash or at least liquid position. These investors can afford to be optimistic, for history suggests that they will get a chance to buy true values during the next year or so.

STOCKS of 432 representative stocks which are tabulated at this office, 245 (57%) are holding above their 200-day moving average. This is a drop of 4% from last week, but the study is still holding above the 50% level -- and therefore must be considered bullish.

The bellwether Tri-Continental Warrants are worth watching closely from now on (see chart). These speculative shares often lead the market (see Letter 242), and the Warrants now appear quite "toppy". Note that the short-term or 10-week moving average (solid line) has now dropped below the longer or 200-day moving average (dotted line) — a bearish sign. A further negative sign is the steady decline in the short interest position in the Warrants (circles connected by lines). I believe the Warrants are now a reasonable short sale — with a mental "stop-buy" at 38.

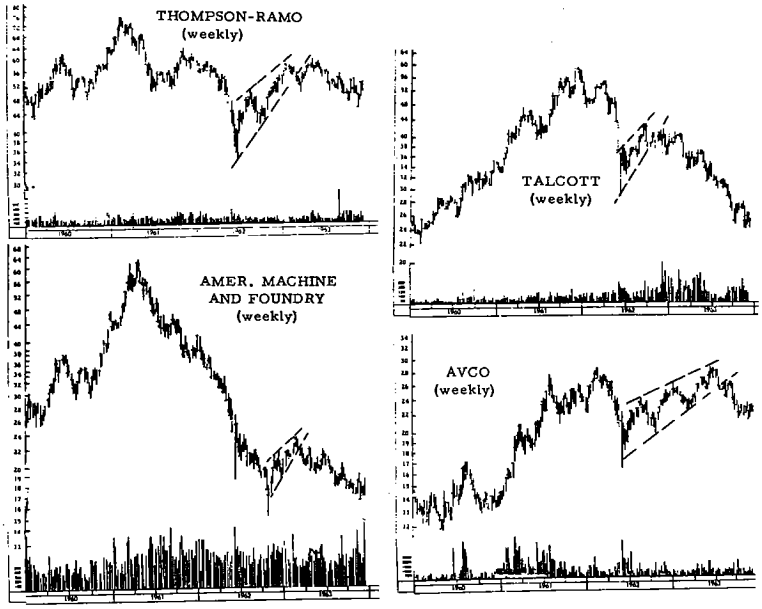




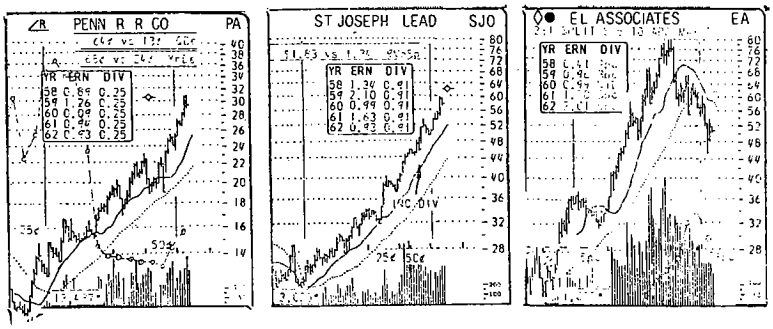
Last week I included a chart which illustrated the remarkable price structure of the London Stock Average. This was described as a "rising wedge" formation, a pattern which is formed by two rising and converging trendlines. The rising wedge represents a situation in which

"demand" is slowly diminishing: it is a characteristic bear market rally pattern, and the breaking of such a structure is usually followed by a major decline.

Interestingly enough, a number of stocks on the N. Y. S. E. have formed wedges, and I have included four weekly charts on page 4, each of which shows the typical wedge structure. Note that these patterns began to form at the 1962 lows, and that in one case (Avco) the wedge took the stock to (but not above) the old high. In another case (Amer. Machine & Foundry) the wedge was completed in a few months, and the stocks promptly sank back towards its 1962 low.



While some stocks have been forming bearish wedges, a few other issues have been tracing almost straight-up patterns known as "stilt formations". Such structure are characteristic of extremely speculative markets; and they are the result of a sudden "explosion of demand" which continues uninterrupted by any major decline or correction. At present, almost all the airline issues are in stilt-patterns as are such stocks as Chrysler, St. Jos. Lead, Penn. R.R., AVC Corp., Burlington, Dr. Pepper, Bulova Watch and Armstrong Cork, to name a few.



As a rule, stilt formations only occur (study the above list of issues) in stocks which are completely "sold-out" (i.e., stocks which are out-of-favor and under long sieges of selling). The majority of the above listed issues were "dormant", greatly undervalued, or were behaving badly for long periods before they "took off" on their stilt-climbs. Chrysler, for instance, was one of the poorest acting of the D-J Industrial issues, and it was actually below its 1949 bottom when it finally turned up in 1961 ! The same was true of St. Joseph Lead, a stock in the formerly very depressed Lead and Zinc group. Most investors had "thrown in the sponge" on Penn. R. R. (Pa. sold for 28 in 1951 and under 11 in 1962) prior to its recent stilt formation. Conclusion, when a stock has been under pressure for years and the situation suddenly changes for the better — a mighty rise can result.

A final point about stilt patterns: the great majority of stilt formations terminate in collapse. The collapse seems to be the normal reaction to the previous explosion. We have just seen something along these lines in Syntex on the Amex, a stock that lost almost half its value in eight trading days. Even high-quality issues such as IBM prove the stilt-collapse rule, and investors will remember that the great 1952-61 stilt climb in IBM ended in 1962 with a crash that cut the price of IBM virtually in half. The small chart of Electronic Associates shows the shattering of its 1962 stilt-formation.

Strongest Groups from the standpoint of relative strength (R. S.) studies are the Airlines, Drugs, Textiles and Business Machines. The "sleeper" may be Rail Equipment, and note (chart below) the slow but steady rise in this group's R. S. The R. S. line has almost touched the top of a three-year (gradually) rising channel. I would guess that it will break out of this channel, and that this will mark the beginning of more dramatic improvement in this group. Best acting in the Rail Equipment group are Pullman and N. Amer. Car, with Westinghouse and N. Y. Airbrake looking interesting. Baldwin-Lima is the low-price speculation in the group.

LATE NOTE: On Friday, January 31, Industrials closed within a few points of their 787. 78 all-time high — while Rails diverged for the second consecutive day. The odds (at this writing, Monday, Feb. 3, 1 P. M., N. Y. time) seem to favor a new Industrial high above point 5 (787. 78) on chart # 1 — and a second full breadth-price divergence. In view of this dangerous situation, I do not even wish to recommend speculations at this time. Take speculative profits (or losses), sit back, and await further developments.

From the standpoint of the waiting speculator, I would be willing to bet that there will be one or more advantageous "buy-spots" between now and the third quarter of this year.

Chart # 1 and top four charts on this page courtesy of Traders Research, 1431 Pearl Ave., Alton, Ill. 62003. Charts of TY Warrants, PA, EA and SJO courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. Last week's chart of Odd-Lot Volume was courtesy of Merrill Analysis, Box 228, Chappaqua, N. Y. (my apologies for the omission, Mr. Merrill).